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August 4, 1997

Mr. David S. Guzy
Chief, Rules & Procedures Staff
Minerals Management Service
Royalty Management Program
P.O. Box 25165, Mail Stop 3101
Denver, CO 80225-0165

Re: Additional RMOGA Comments on MMS Supplementary Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases and on Sale of Federal Royalty Oil - 62 F.R. 36030, published July 3, 1997

Dear Mr. Guzy:

The Rocky Mountain Oil & Gas Association (RMOGA) is pleased to have the opportunity to provide additional comments on the Minerals Management Service's Supplementary Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases and on Sale of Federal Royalty Oil - 62 F.R. 36030, published July 3, 1997.

RMOGA is a regional trade association representing hundreds of members, large and small, who account for more than 90% of the oil and gas exploration, production, refining, transportation and marketing activities in the Rocky Mountain region.

Attached for filing please find a report from the Barents Group, L.L.C. titled "*Analysis of the Department of the Interior, Minerals Management Service Supplementary Proposed Rule Establishing Oil Value for Royalty Due on Federal leases and on Sale of Federal Royalty Oil Under the Paperwork Reduction Act.*" In the effort to fully participate in this rulemaking process, RMOGA offers this report as additional substantive comments on the supplemental proposal above-referenced.

Sincerely,

Clifford F. Dodge

Clifford F. Dodge
RMOGA Executive Vice President

Enc.

pc: Wayne Pachall, Texaco
Patricia Dunmire Bragg, Gardere & Wynne, L.L.P.

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To	Maureen Edwards	August 4, 1997	
Organization	RMOGA	Pages	34
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From	Lin Smith		
Tel	202-467-3828		
Fax	202-728-0546		
Subject	MMS Sumission on Oil Valuation		

Maureen,

A clean copy of this report is on its way to KPMG's Denver office for delivery to you ASAP. The person who is handling it for me is Noel Baker. The office number is 303-296-2323.

I would prefer having that copy filed, but this fax copy can be a backup.

Please let me know if you have any problems. If I should be unavailable, please contact Julie Topoleski at 202-467-3650.

Lin

ANALYSIS OF THE DEPARTMENT OF INTERIOR, MINERALS MANAGEMENT SERVICE SUPPLEMENTARY PROPOSED RULE ESTABLISHING OIL VALUE FOR ROYALTY DUE ON FEDERAL LEASES AND ON SALE OF FEDERAL ROYALTY OIL UNDER THE PAPERWORK REDUCTION ACT

Prepared by

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August 4, 1997

PREFACE

Barents Group LLC, a wholly owned subsidiary of KPMG Peat Marwick LLP, was retained by Gardere & Wynne LLP on behalf of a group of companies having significant crude oil production on Federal lands, to assist in analyzing the Department of Interior, Minerals Management Service (MMS) supplementary proposed rule establishing a new method for valuing oil for royalties due on Federal leases, and on the sale of Federal royalty oil (62 F.R. 36030, published July 3, 1997). These companies are interested in and affected by the MMS proposal. This report addresses the issues raised by the proposed rule under the Paperwork Reduction Act (PRA).

For the purposes of this report, we have utilized certain terminology defined by MMS in its proposed rule, though we understand that these terms are not necessarily recognized or commonly used in the oil industry. The term "index pricing point" refers to the "physical location where an index price is established" – specifically, Cushing, Oklahoma, for the New York Mercantile Exchange (NYMEX) futures price, and San Francisco and Los Angeles for the Alaska North Slope (ANS) spot price. The term "market center" is defined by MMS as "a major destination point for crude oil sales, refining, or transshipment" – for example, St. James, Louisiana, and Guernsey, Wyoming. MMS has initially defined seven locations as market centers, including the "index pricing points." The term "aggregation point" is defined by MMS as "a central point where production from various leases or fields is aggregated for shipment to market centers or refineries – including, but not limited to, blending and storage facilities and connections where pipelines join." MMS proposes to publish periodically the aggregation points associated with each market center.

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EXECUTIVE SUMMARY

Barents Group LLC, a wholly owned subsidiary of KPMG Peat Marwick LLP, was retained by Gardere & Wynne LLP on behalf of a group of companies having significant crude oil production on Federal lands, to assist in analyzing the Department of Interior, Minerals Management Service (MMS) supplementary proposed rule establishing a new method for valuing oil for royalties due on Federal leases, and on the sale of Federal royalty oil. This report addresses the issues raised by the original and supplementary proposed rules under the Paperwork Reduction Act (PRA).

The proposed rule requires that a new form, Form MMS-4415, be filed for exchange and buy/sell agreements. MMS proposes to use the information collected on the form to calculate location/quality differentials between MMS-specified "aggregation points" and "market centers."

MMS estimates that the respondent burden of complying with the requirements of Form MMS-4415 will be 32,000 hours per year. Many companies have challenged this figure in their comments, citing numerous erroneous assumptions underlying MMS' estimate.

The Paperwork Reduction Act (PRA) of 1995 requires that Federal agencies work to reduce the paperwork burden that information collections impose on respondents, as well as on Federal agencies. The Office of Management and Budget (OMB) has set paperwork reduction goals for each of the next five years. In contrast, the paperwork burden imposed by MMS has been growing slowly in recent years and increased dramatically in 1997. The proposed form would further increase the paperwork burden imposed by MMS.

Under the PRA, OMB must approve all information collections and new forms. OMB rejected MMS' initial request for a new collection of information and asked that MMS address three concerns before resubmitting this request for an information collection. First, MMS must clarify the instructions to the form to eliminate potential misunderstandings. Second, MMS must consider further reducing the universe of respondents required to submit this information. Finally, MMS must further detail how the information collected on Form MMS-4415 will be used to calculate the differentials required in the proposed rule.

Our analysis demonstrates that the supplementary rule is not responsive to either industry or OMB concerns. Further, we find that the proposed use of the information collected on Form MMS-4415 would create risk and uncertainty in crude oil valuations and result in economic inefficiencies. Less burdensome alternatives to the proposed rule are available, and MMS should consider these before proceeding with an interim or final rule.

ANALYSIS OF THE DEPARTMENT OF INTERIOR, MINERALS MANAGEMENT SERVICE SUPPLEMENTARY PROPOSED RULE ESTABLISHING OIL VALUE FOR ROYALTY DUE ON FEDERAL LEASES AND ON SALE OF FEDERAL ROYALTY OIL UNDER THE PAPERWORK REDUCTION ACT

1. INTRODUCTION

On January 24, 1997, the Minerals Management Service (MMS) published a proposed rule establishing oil value for royalty due on Federal leases and on sale of Federal royalty oil (62 F.R. 3742). In compliance with the PRA and other statutory and regulatory requirements, MMS estimated the regulatory burden associated with the proposed rule and solicited comments.

On March 25, the Domestic Petroleum Council, the Independent Petroleum Association of America, the Independent Petroleum Association of Mountain States, the Mid-Continent Oil and Gas Association, and the Rocky Mountain Oil and Gas Association submitted a report prepared by Barents Group LLC to the Office of Management and Budget (OMB) commenting on the proposed rule.[1] In response to these and other industry comments, as well as its own analysis, OMB denied MMS' request to collect information on proposed Form MMS-4415. The information to be collected on this form would be necessary to implement the proposed rule.

On July 3, MMS released a supplementary rule intended to address certain concerns raised during the comment period.[2] Barents has been asked to review the supplementary rule to analyze whether MMS has significantly reduced the paperwork burden. In reviewing the supplementary rule, we find that while MMS has addressed certain relatively minor issues, MMS has not addressed the substantive issues raised by the industry or by OMB. In addition, the supplementary rule creates new problems. We addressed some of these new concerns in a May 28, 1997 submission to MMS that commented on an earlier draft of the supplementary rule.[3]

We begin with an overview of the proposed rule and the supplementary proposed rule (Section 2), followed by a discussion of the PRA requirements (Section 3). Section 4 discusses OMB's review under the PRA and contains a discussion of industry's and OMB's comments. Section 5 discusses problems not addressed by the supplementary rule and new problems it creates. Section

[1] "Preliminary Analysis of the Department of Interior, Minerals Management Service Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases and on Sales of Federal Royalty Oil," March 25, 1997 as submitted by the Domestic Petroleum Council, the Independent Petroleum Association of America, the Independent Petroleum Association of Mountain States, the Mid-Continent Oil and Gas Association, and the Rocky Mountain Oil and Gas Association.
[2] All references to the supplementary proposed rule in this report refer to 30 CFR Part 206 as published in the Federal Register, July 3, 1997, Volume 62, No. 128.
[3] "Analysis of the Department of Interior, Minerals Management Service Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases and on Sales of Federal Royalty Oil," May 28, 1997 as submitted by the Rocky Mountain Oil and Gas Association.

6 discusses other options for valuing crude oil for royalty purposes. Section 7 describes other requirements MMS has not adequately addressed under the PRA. Finally, section 8 presents our conclusions.

Before discussing the Paperwork Reduction Act, we briefly note that MMS is required to comply with several other administrative requirements in proposing a rule. One of these is Executive Order 12866, which requires the preparation of a detailed cost-benefit analysis for rules that have significant economic effects. For this purpose, private sector costs in excess of $100 million annually are considered significant. When discussing Executive Order 12866 in the proposed rule, the agency stated that the rule will not have significant economic effects [page 3750]. In a previous submission supporting this conclusion, the MMS estimated that the rule would result in additional revenues of $54.2 million and industry reporting costs of $845,600.

This finding has now been called into question by a member of Congress. In July 31, 1997 testimony before the House Resources Committee, Subcommittee on Energy and Mineral Resources, Congresswoman Carolyn Maloney (D-NY) stated that the proposed MMS oil valuation rule would annually raise $100 million in revenue to the U.S. Treasury. Particularly when Congresswoman Maloney's estimated costs are added to other costs described in this report, as well as in numerous other comments provided during the public comment period, it is clearly appropriate for MMS to perform the more detailed economic analysis required by Executive Order 12866 to determine whether the rule has significant economic effects.

2. OVERVIEW OF PROPOSED AND SUPPLEMENTARY PROPOSED RULE

ORIGINAL PROPOSED RULE

The proposed rule seeks to decrease reliance on posted prices and to develop rules for Federal royalty valuation which will better reflect market value of crude oil at the lease.[4] It retains the concept that for arm's-length sales, gross proceeds are the basis of royalty value, but it limits the application of this concept. The majority of sales would be subject to a new index methodology in which the royalty value is linked to either the New York Mercantile Exchange (NYMEX) futures price for West Texas Intermediate (WTI) at Cushing, Oklahoma or the Alaska North Slope (ANS) spot price for deliveries in either Los Angeles or San Francisco, depending on the location of production. The transactions required to use this new methodology include exchange agreements, reciprocal buy/sell agreements, non-arm's length transactions, sales to an affiliate refiner, and production subject to a crude oil call. The proposed rule would also require lessees to file a new form, Form MMS-4415, for all exchange agreements. The information collected on the new form would be used to calculate location/quality differentials between aggregation points and market centers. An Appendix contains a copy of the proposed form and instructions.

Proposed Form MMS-4415 would impose new reporting and record-keeping burdens on Federal lessees. Initially, the form must be submitted no later than two months after the effective date of the information requirement and then by October 31 of the year in which the rule takes effect and by October 31 of each succeeding year. The form requests information on the terms of the contract including: contract party name, contract type and ID, contract term, title transfer location, volume terms, crude quality (including API gravity and sulfur content), pricing terms, and quality adjustments. As we later discuss in more detail, the form's instructions currently leave much room for misinterpretation, and such misinterpretation could render any information collected unusable for the intended purpose. Additionally, much of the information to be collected on the proposed form is not currently maintained in company accounting or administrative systems. Developing systems to collect, organize, and retain the information would require considerable time and money.

Royalty valuation at the lease for non-arm's-length transactions is proposed as follows: Where oil is transferred to an affiliate who later sells it at arm's length, the value of the oil for royalty purposes will be either

1. the affiliate's arm's-length resale price (provided that neither the lessee nor its affiliate also purchases oil) or
2. a "monthly average" of the NYMEX futures price (for non-California and non-Alaska oil) or ANS spot price (for oil produced in California or Alaska), adjusted for location and/or quality differentials.

[4] All references to the proposed rule in this report refer to 30 CFR Part 206 as published in the Federal Register, January 24, 1997, Volume 62, No. 16.

For all other cases (i.e., where the lessee or its affiliate refines the oil or disposes of it in a non-arm's-length transaction), only the second option will be available.

Three adjustments to the "monthly average" NYMEX futures price are described by MMS:

1. a "location/quality differential" between the "index pricing point" (for example, West Texas Intermediate (WTI) at Cushing, Oklahoma) and the appropriate market center (for example, Light Louisiana Sweet at St. James, Louisiana), calculated as the difference between the average monthly spot prices published in an MMS-approved publication for the respective locations;
2. a "location/quality differential" between the "market center" and a "major aggregation point" for oil from various sources, as either published by MMS or contained in the lessee's arm's-length exchange agreement (this adjustment would be based on data collected on Form MMS-4415) or the company's own differential on a buy/sell or exchange between a market center and an aggregation point; and
3. the actual costs of transportation (as determined under existing valuation rules) from the "aggregation point" to the lease, or from the "market center" to the lease if the oil flows directly to a "market center."

SUPPLEMENTARY PROPOSED RULE

On July 3, 1997, MMS published a supplementary proposed rule which modifies the eligibility requirements for oil valuation for arm's-length transactions and the procedures for collection of exchange information.[5] It also amends the list of aggregation points. This section discusses changes to the proposed rule contained in the supplementary proposed rule.

Modifications in Reporting Requirements

The supplementary proposed rule does not significantly change the reporting requirements of proposed Form MMS-4415. It contains no changes to either the proposed form or its instructions. The only change in reporting requirements is that MMS will only require Form MMS-4415 to be filed for transactions between an aggregation point and a market center and will not require a Form MMS-4415 to be filed for oil exchanged at the lease. MMS is seeking comments on the usefulness of collecting information on exchanges between two aggregation points.

The supplementary rule is unclear about whether MMS will require Forms MMS-4415 to be filed for exchanges of non-Federal oil. If only Federal oil is commingled at any aggregation point, then MMS will only need the information on that Federal oil to be filed on Form MMS-4415, but MMS is seeking comments on how lessees would allocate differentials to Federal leases when both Federal and non-Federal oil are commingled at any aggregation point.

[5]Federal Register, July 3, 1997. Volume 62, No. 128.

Modifications in Valuation Methodology

Under the proposed rule, MMS would require that all production subject to a crude oil call be valued using the proposed index methodology. MMS has received many comments regarding oil subject to crude oil calls; crude oil calls are frequently not exercised, and when they are exercised, the purchaser must typically match or exceed the price offered by the highest bidder. In these cases, MMS will not require the oil to be valued using an index pricing method. The supplementary proposed rule amends 30 CFR 206.102(a)(4) to require index valuation only in situations involving non-competitive crude oil calls and adds a definition of a non-competitive crude oil call in 30 CFR 206.101. The supplementary proposed rule also deletes 30 CFR 206.102(a)(6), as proposed in January, to address the issue that disallowing producers who purchased small quantities of oil for on-lease and other uses is too restrictive.

MMS is proposing a new paragraph (a)(6) to allow producers who exchange oil with a non-affiliated entity, and then sell the oil in an arm's-length transaction, to value that oil using gross proceeds or to choose to use an index methodology. This paragraph would only apply if there is a single exchange agreement before the arm's-length sale.

MMS also proposes to exclude an additional category of arm's-length transactions from gross proceeds valuation. The preamble states "[t]hat these are situations where two parties transact purchases and sales of oil that would appear to be arm's length. However, the prices are below market for the field or area. Neither party cares because they agree to sell roughly equivalent volumes to one another..." [page 36031]. In this situation, referred to as an "overall balance" situation, the supplementary proposed rule amends 30 CFR 206.102(a)(4) to require the oil to be valued based on index value.

Finally, MMS amends 30 CFR 206.102(a)(1) to clarify that the exceptions to valuing oil based on gross proceeds should be applied on a contract-by-contract or transaction-by-transaction basis.

3. REQUIREMENTS OF THE PAPERWORK REDUCTION ACT

Under the PRA of 1995 (5 CFR 1320), Federal agencies must "reduce, minimize and control burdens and maximize the practical utility and public benefit of the information created, collected, disclosed, maintained, used, shared and disseminated by or for the Federal government." Agencies proposing to collect information must submit a proposal to the OMB. Before OMB approves a proposed collection of information, agencies must meet a number of requirements. A discussion of the primary requirements follows.

FEDERAL AGENCY REQUIREMENTS

First, a notification of the proposed collection of information must appear in the Federal Register. This announcement should provide various background details on the proposal, as well as a description of probable respondents, an estimated number of respondents, and the estimated regularity with which responses are required. The notice should also furnish an estimate of the associated annual costs.

An agency must review various aspects of the collection of information before submitting its proposal to the OMB. This review should evaluate the need for the collection of information, describe the information to be collected, outline a plan for the collection of information, estimate the burden imposed by the collection of information, provide support for this estimate, evaluate the possible application of information technology to the collection process, implement a pilot program to test the collection of information (if appropriate), and outline a plan that ensures efficiency in the information collection process.

In addition to this review, an agency must give the public and any affected agencies the opportunity to evaluate and respond to the proposed collection of information. The agency must also provide the OMB with a summary of the comments collected and any response the agency made to these comments. OMB has the authority to reject a proposed collection of information if it determines that the agency did not adequately respond to these comments.

Finally, an agency must provide certification and evidence that a variety of obligations have been fulfilled. For example, the agency must demonstrate that the proposed collection of information is necessary for the agency to perform its duties, and that the proposed collection has some confirmed use. The proposed collection should not cause unnecessary duplication of information, such that information already available to the agency is not re-accumulated. Also, the burden imposed on respondents, as well as to the agency, must be minimized through, for example, the design of the proposal or the use of information technology. OMB emphasizes that agencies demonstrate that every reasonable effort to accommodate small entities have been made. Agencies should assist small entities by changing their compliance and reporting requirements, simplifying these requirements, or releasing these entities from satisfying all or part of these requirements.

The following requirements address the impact of the proposed collection of information on possible respondents. The proposed collection of information must be written simply so that it is understandable to all possible respondents. In addition, the proposal should be designed so that the reporting requirements cause the least disruption in the reporting and record-keeping methods of the respondents, i.e., the method of information collection should be compatible with the record-keeping methods of the respondents. The agency must explain to the potential respondents the purpose of the information collection, the manner in which the information is to be used, whether the response to the collection is obligatory, and the extent of the confidentiality required. Finally, the agency must provide a reasonably accurate estimate of the burden imposed on the respondents by the collection of information.

Regarding the effect of the information collection on the agency, it must provide evidence that the proposal is structured in such a way that the agency will efficiently manage and use the information collected. Appropriate statistical survey methods, as well as information technology, should be employed, to the maximum extent possible, to promote efficiency in the processes used to collect and apply the information.

Thus, the main objective of the Act, as indicated by the above requirements, is to ensure that the costs incurred by both the respondents and the agency do not exceed the benefits of the collection of information. Similarly, if the information can be collected in a manner that imposes fewer costs, that method should be applied.

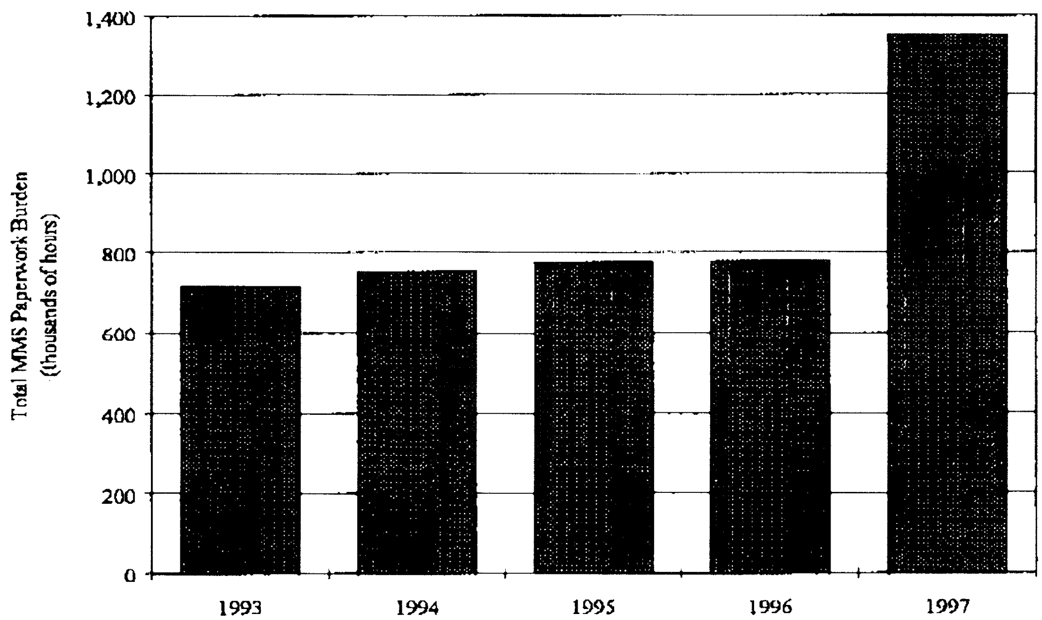
MMS PERFORMANCE

The PRA requires the Office of Information and Regulatory Affairs (OIRA) to set a goal of at least a 10 percent paperwork burden reduction government-wide for each of fiscal years 1996 and 1997 and a 5 percent government paperwork burden reduction goal for each of the succeeding four fiscal years. Each agency is responsible for reducing its own paperwork budget and is supposed to set goals to help attain the overall target level. Each agency is also responsible for providing OIRA with its estimates of the paperwork burden of each of its information collections.

Recent history shows that MMS' paperwork budget has been rising slowly, but as Figure 1 shows, in 1997, it increased dramatically. This increase is largely attributable to three new requirements: 30 CFR Part 250, Subpart D – Oil and Gas Drilling Operations which requires that a lessee take precautions to keep its wells under control at all times (116,505 hours); 30 CFR Part 250, Subpart C – Pollution Prevention and Control which requires that the lessee take measures to prevent unauthorized discharge of pollutants into offshore waters (149,510 hours); and the delegation of authority to the States (210,400 hours).

Figure 1

Total MMS Paperwork Burden, 1993-1997



Source: Active Information Collections provided by Docket Library, Office of Information and Regulatory Affairs, Office of Management and Budget

As discussed in Section 4, MMS estimates that proposed Form MMS-4415 will require 32,000 hours for lessees to complete, an estimate we believe to be too low. Thus, the addition of proposed Form MMS-4415 will only increase the paperwork burden imposed by MMS.

4. OMB REVIEW UNDER PAPERWORK REDUCTION ACT

OMB'S RESPONSE TO MMS' REQUEST FOR NEW INFORMATION COLLECTION

On April 15, 1997 OMB rejected MMS' request for approval of a new information collection using Form MMS-4415. OMB raised the following concerns with the proposed form which MMS should have addressed before submitting a new request for an information collection:

A. MMS must clarify the instructions to the form to eliminate potential misunderstandings;
B. MMS must consider further reducing the universe of respondents required to submit this information; and
C. MMS must further detail how this information will be used to calculate the location differentials required in this rulemaking.[6]

We discuss each of these issues in turn.

A. MMS must clarify the instructions to the form to eliminate potential misunderstandings.

MMS was unclear in specifying who should file Form MMS-4415. The instructions refer only to the royalty payor while the proposed rule associates the reporting burden with the lessee (and its affiliates). If only the lessee is required to file the form, it may have insufficient data to complete the form. If the payor and lessee are different, and the payor files the form, it is unclear whether the payor's payor number or the lessee's payor number should be used. The instructions are not clear with the result that the form's requirements may be misinterpreted. That misinterpretation could render the results meaningless unless substantial additional guidance is provided.

The instructions also require that the filer provide a contract number which would allow a third party to identify the document. Because a contract number is generally an internal company number, obtaining and using both parties' numbers would create an additional burden as the other party's contract number is not usually readily available. On the other hand, if MMS is unable to directly link two or more forms filed that describe the same contract, they will give disproportionate weight to that contract in its published oil price differential.

It is also not clear how and where to report contractually specified charges and costs (i.e., location differentials and gathering/handling charges) that are not identified on the form as adjustments.

The supplementary proposed rule provides no additional guidance on who should file Form MMS-4415: the royalty payor or the lessee. The preamble notes that industry comments asked

[6] Paperwork Action Summary. Office of Management and Budget, Office of Information and Regulatory Affairs. April 15, 1997.

for clarification on who should file Form MMS-4415 and what information is required. Within that same paragraph, MMS refers to both lessees and payors. It states, "[t]o calculate specific differentials, MMS would take the volume-weighted average of the individual differentials derived from information *payors* report on Form MMS-4415.... *Lessees* would not be required to report information from exchanges where oil is exchanged at the lease." [Page 36032, emphasis added].

While MMS clarifies in the supplementary rule that they will only collect data on exchanges between aggregation points and market centers, they provide no additional guidance on how the form should be completed, and so the potential for misinterpretation remains. As we note in our March 25, 1997 report, errors in completing the form could require that MMS follow up with the company or discard the form. At a minimum this will require substantial additional time for the company and MMS. Even worse, MMS will very likely find that without substantially greater guidance, inconsistent and contradictory interpretations of the instructions will render meaningless any statistical aggregation and reporting.

B. MMS must consider further reducing the universe of respondents required to submit this information.

In our March report, we discussed that much data MMS would collect under the proposed rule would not be usable for MMS' stated purpose of developing quality and location differentials between market centers and aggregation points. The proposed rule required that a Form MMS-4415 be filed for each exchange agreement resulting in a large amount of unusable data.

The supplementary proposed rule limits information collection to exchanges between aggregation points and market centers, but MMS is seeking comments on the usefulness of collecting information about exchanges between two aggregation points. The supplementary rule also states that if only Federal production is commingled at any aggregation point, MMS will only collect information on that Federal production. MMS is seeking comments on how lessees would allocate differentials to Federal leases if both Federal and non-Federal production are commingled at any aggregation point. While this would reduce the number of Forms MMS-4415 required to be filed by each respondent, it does raise issues of statistical accuracy, a subject we address in Section 5 of this report.

C. MMS must further detail how this information will be used to calculate the location differentials required in this rulemaking.

As we note in our March report, it may not be possible to derive statistically valid differentials based on information collected on Form MMS-4415 because the adjustments contained in actual sales, exchange, and buy/sell agreements represent several factors that can be impossible to disentangle. In order for the differentials to be meaningful adjustments for market valuation, MMS will need to develop a schedule that provides incremental allowances for gravity and sulfur differences for each market center/aggregation point pair.

The possibility of having only a few transactions between any aggregation point and market center also results in potentially serious problems with the statistical accuracy and representativeness of the "location/quality" differentials. This problem could be compounded by the requirement that duplicate information does not have to be reported (i.e., identical location/quality differential between the same points) [page 3749]. If a lessee has four high-volume sales of 10,000 barrels each to one point with identical quality/location differentials and only has to report one, and the only other sales to that point are low volume sales with different prices, the MMS calculated differential would underrepresent the location/quality differential for those four sales by three quarters.

In the supplementary proposed rule, MMS explains that it will calculate specific location and quality differentials by taking the volume-weighted average of the individual differentials derived from the information payors report on Form MMS-4415 [page 36032]. MMS provides no additional detail on how it will address any issues of statistical validity that arise.

INDUSTRY COMMENTS ON MMS' PROPOSED RULE

The industry commented extensively on record-keeping and administrative burdens that would result from the proposed rule. In our March 25, 1997 report, we commented on the burden proposed Form MMS-4415 would place on companies, the systems costs associated with the new form, the treatment of transportation costs, the complex compliance issues regarding what constitutes like-quality oil, and the costs of issuing an interim rule. This section discusses each of these issues and how these issues have or have not been addressed by MMS in the supplementary proposed rule.

A. MMS' assumptions about the burden of complying with proposed Form MMS-4415 are incorrect.

MMS has a duty under the PRA to minimize the burden of any new information collection on respondents and on itself. The proposed rule would impose substantial costs on lessees, their affiliates, and their designees, as well as on MMS itself. These costs include substantial day-to-day administrative and record-keeping burdens for companies required to file Form MMS-4415.

MMS estimates the private sector reporting cost resulting from the proposed rule to be approximately $800,000 per year, resulting from 32,000 hours of additional work.[7] This estimate is based on the following assumptions: there are approximately 2,000 royalty payors on Federal leases; the average royalty payor has 64 relevant sales contracts and exchange agreements; a lessee will take 15 minutes to gather the necessary information and complete the Form MMS-4415; and average labor costs are $25 per hour.

The industry has challenged these assumptions, indicating that the actual costs would be significantly higher. First, various companies claim that the number of sales contracts and exchange agreements to be reported would be greater than 64, the number estimated by MMS. For example, BP Exploration & Oil Inc. estimates that it and its affiliates are involved in about 200 exchange agreements annually that might be affected by the proposed rule.[8] Similarly,

[7] Federal Register. Vol. 62, No. 16 at 3750.
[8] BP Exploration & Oil Inc. comments to Minerals Management Service, pages 12-13. May 23, 1997.

Monterey Resources, Inc. reports that it engages in hundreds of such agreements every year.[9] MMS' estimate is even more questionable given the figures presented by Conoco Inc. and Texaco Inc. Conoco has over 900 contracts,[10] whereas Texaco has about 1,377 contracts[11] that would, at a minimum, need to be reviewed to determine their relevance to Form MMS-4415.

Second, companies addressing MMS' 15-minute assumption indicate that the time necessary to collect the relevant data and complete the form would be far greater than the 15 minutes described by MMS. Companies must perform a variety of tasks before they can even begin filling out the proposed form. These tasks include:

- researching the contract terms,
- reporting transportation costs on a segment-by-segment basis,
- determining the existence of a call on production,
- collecting data from various divisions or affiliates of the company, and
- researching information not evident in the contracts.

Although 15 minutes might be adequate to fill out each form, BP contends that "it might require many multiples of this to identify and collect all applicable exchange agreements and to extract the necessary information and do the required calculations."[12] Conoco estimates that it would take two hours to complete the MMS-4415, resulting in "900 man-days (8-hour days) to accomplish the review of an entire year's contracts in order to fill out MMS Form-4415 properly."[13] Similarly, Texaco estimates that this initial review process alone would take about three person-years to complete.[14]

The burden is further increased because some information required on Form MMS-4415 is not generally kept at the sales transaction level. For example, a producer may know the sulfur content at the lease, but often production is commingled or aggregated with other types of crude to fulfill the terms of a contract. To determine the sulfur content at the title transfer point would require an additional sulfur measurement at an additional cost to the producer.[15]

Additionally, the number of Forms MMS-4415 that must be filed each year could be compounded, depending on exactly what circumstances require the filing of a new form. The proposed rules are unclear as to whether a new form must be filed any time any facet of a contract changes. This could dramatically increase the burden and time required to compile the necessary data and file the form.[16] This requirement poses a particularly difficult problem in that the collection of data on changes in contract terms is needed to assure the statistical accuracy of MMS' calculations, but it would greatly increase the estimated reporting burden.

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[9] Monterey Resources, Inc. comments to Minerals Management Service, page 7. May 16, 1997.
[10] Conoco Inc. comments to Minerals Management Service, page 5. May 23, 1997.
[11] Texaco Inc. comments to Minerals Management Service, page 28. May 28, 1997.
[12] BP Exploration & Oil Inc. comments to Minerals Management Service, page 12. May 23, 1997.
[13] Conoco Inc., page 6.
[14] Texaco Inc., page 28.
[15] Council of Petroleum Accountant's Societies (COPAS) comments to Minerals Management Service, page 9. May 27, 1997.
[16] Council of Petroleum Accountant's Societies (COPAS), page 8.

Finally, many companies dispute MMS' assumption that labor costs relating to the Form MMS-4415 would be only $25 per hour. As discussed in our March 25, 1997 report, and reported by the Rocky Mountain Oil and Gas Association, an appropriately skilled employee would cost about $36 per hour, excluding overhead costs.[17] This figure is more reasonable, given that the employee must be able to interpret a variety of contracts and be able to determine the relevant data to be included in the Form MMS-4415. In addition, as noted in our March report, it is unlikely that a skilled analyst in the private sector would cost less than a GS-9 whose responsibilities are to collect and file Federal documents.[18]

The reporting burden of the proposed rule is not limited to integrated producers or large independents; it will also be felt by small producers. While many small companies had neither the time nor the resources to comment extensively on the burden that would be imposed on them by proposed Form MMS-4415, those who did comment indicated that the new reporting requirements would indeed be expensive and burdensome to implement.[19]

Thus, MMS' estimates are understated because their assumptions are incorrect. This further indicates that MMS rule writers simply do not understand how business is conducted and records are kept in the industry. Figures calculated and reported by numerous companies and associations demonstrate that the burden far exceeds the $800,000 originally suggested by MMS.

Moreover, some of the efforts expended to complete the form will be wasted in duplication. Such duplication would occur when two Federal lessees are required to report the same transaction. Indeed, if MMS does not exercise great care in its analysis, there is a risk that the analysis could be distorted by counting some transactions twice.

The majority of companies commenting on the proposed rule addressed the burdens imposed by Form MMS-4415, demonstrating the prevalence of the issue. However, MMS has failed to meaningfully respond to these comments in the supplementary rule.

B. Large systems development and implementation costs are necessary to manage the data required on Form MMS-4415.

Another component of the burden imposed by Form MMS-4415 results from the considerable resources both lessees and MMS would be required to commit to manage, monitor, and audit the information required by the form. Companies will be obligated to compile and report a large volume of data that they do not currently maintain in a systematic way and are not required to provide under current lease terms. For example, the form requests detailed information on all

[17] Rocky Mountain Oil and Gas Association comments to Minerals Management Service, page 6. May 28, 1997.

[18] In a recent information collection solicitation regarding Form MMS-4109 [FR 37930, July 15, 1997], MMS assumed $35 per hour in estimating the industry cost burden. It is doubtful that the skill level required to complete Form MMS-4415 is lower than that required for completing Form MMS-4109.

[19] Companies commenting on the burden of proposed Form MMS-4415 include Bellwether Exploration Company, Nuevo Energy Company, and Phoenix Production Company. In addition, many companies support the comments of the Wyoming Independent Producers Association, the Rocky Mountain Oil and Gas Association, and the Western States Petroleum Association, each of which comment briefly on the reporting burden.

exchange agreements, including data on transfer location, volume, quality, pricing, and adjustments. As a result, the required collection of information not only imposes large day-to-day costs of gathering data, but also large start-up costs. Few, if any, companies have an administrative, accounting, or record-keeping system in place that is capable of responding to MMS' request.

System start-up costs include expensive and time-consuming efforts to design, build, and test systems. In addition to redesigning entire systems, companies may need to hire additional skilled employees and retrain existing employees to run the systems and fulfill the requirements of the proposed form. Phillips Petroleum Company estimates that costs for reprogramming its systems alone would be in excess of $400,000.[20]

Even the largest companies with sophisticated record-keeping and administrative systems will face large costs. This is primarily the result of two separate factors. First, to maintain efficient operations, companies retain only the data they need for legal and business reasons. Much of the data requested by MMS is not currently required on a routine basis and, thus, is not computerized. Second, the data that are computerized are often maintained on different systems, and for different purposes, that are not designed to communicate with each other. For example, large companies typically operate separate upstream and downstream systems for separate affiliates. New systems will also have to be implemented by MMS to enable them to review and analyze the data they receive.

The case of Shell Oil Company demonstrates how the complexity of designing new systems increases when a company has a number of affiliates or separate legal entities. The data necessary to complete the form do not reside in one central location, but "involve several different corporations, each of which is separate and distinct, each of which has different employees, business missions, and record-keeping procedures."[21] Texaco, a company whose structure is also complex, "would require skilled computer programmers to perform analyses, design, construction and implementation activities that are currently estimated to encompass over five person-years..."[22]

Again, a number of companies addressed the burden of setting up systems to handle the requirements of Form MMS-4415 in their comments to MMS. However, MMS failed to respond to these concerns in its supplementary proposed rule. The systems costs imposed by the Form MMS-4415 are extensive and represent a substantial burden: a burden MMS is obligated to limit and justify under the PRA.

C. Disallowing the use of FERC tariffs is burdensome, expensive, and inequitable.

The proposed rule requires that companies make transportation adjustments based on actual costs and eliminates the lessee's ability to use Federal Energy Regulatory Commission (FERC) and State-approved tariffs when computing royalties. This requirement will result in substantial

[20] Phillips Petroleum Company comments to Minerals Management Service, page 1. May 28, 1997.
[21] Shell Oil Company comments to Minerals Management Service, page 42. May 27, 1997.
[22] Texaco Inc., page 29.

compliance and administrative costs and inequities. Additionally, substantial costs will be incurred by many pipeline companies, and competing shippers will be treated inconsistently.

The instructions to proposed Form MMS-4415 require that transportation costs be presented in segments if production travels through more than one aggregation point. Costs are generally not accounted for in this manner and to do so would require significant effort on the part of production and pipeline companies.[23] Additionally, if a contract involves production from more than one lease, there could be different transportation arrangements from each lease, adding to the effort required to construct actual costs.

The establishment of cost-based tariffs is a highly labor-intensive process and often requires incurring outside consulting and legal fees that FERC was largely able to eliminate through regulatory action taken in 1993. MMS would effectively eliminate all cost savings that FERC achieved in this area.

In its comments filed with MMS on May 27, 1997, Chevron Pipeline Company (CPL), a common carrier, discusses the burden that the disallowance of FERC tariffs will impose on it, and also on MMS. The proposed rule details what may be included in actual cost, and the "regulations do not track the manner in which CPL is required to maintain records under the Uniform System of Accounts for Oil Pipelines established by the FERC....Nor do the MMS regulations calculate a pipeline's costs in the same manner as the FERC does in determining if a pipeline's rates are just and reasonable under the ICA [Interstate Commerce Act]."[24] Complying with the proposed regulations would require that CPL generate new and different financial analyses and records than it keeps in the ordinary course of business.

In addition to calculating the costs in accordance with MMS regulations, CPL would then have to calculate it affiliate's (Chevron Production Company) portion of the costs. Chevron Production Company may not be the only shipper on a given system, and the issue of how costs should be allocated fairly among shippers is often contentious. CPL has approximately four dozen tariff rates for movements originating on the OCS, and assuming Chevron Production Company ships under each of these tariffs, CPL would have to compile and allocate cost data for each of these. They estimate that this would require an initial effort of at least five person-weeks. If there is any dispute over the cost data or allocation methodology, the burden on CPL would increase significantly.[25]

Not only will the requirement to use actual transportation costs place a huge burden on pipeline companies and their affiliates, but it also creates inequities because the rule only requires companies affiliated with a transportation company to use actual costs. If a shipper is unaffiliated with a pipeline, it may continue to pay FERC tariffs to the unaffiliated pipeline. This results in shippers with an equity interest in a pipeline being required to use actual cost calculated according to MMS rules, while competitors could deduct higher actual tariffs for shipments through the

[23] Council of Petroleum Accountant's Societies (COPAS), page 9.
[24] Chevron Pipeline Company comments to Minerals Management Service, page 8. May 27, 1997.
[25] Chevron Pipeline Company, page 9.

same pipeline. This can also place companies with an equity interest in, or affiliated with, a pipeline at a competitive disadvantage.

D. MMS imposes an increased burden on lessees and on itself by not defining "like-quality oil" or other situations where companies should request an MMS calculated differential.

An additional cost of the proposed rule will result from the compliance considerations of what constitutes "like-quality oil." Under proposed paragraph (c)(1)(iii), section 206.105, when a lessee's production is not actually moved to a "market center" but is instead moved directly from the lease to its ultimate disposal site, the proposed rule requires the lessee to calculate a "location differential" based on "the market center nearest the lease where there is a published spot price for crude oil of like quality to your oil. Like-quality oil would mean oil with similar chemical, physical, and legal characteristics" [page 3748]. For example, MMS considers West Texas Sour and Wyoming Sour to be "like crudes" for this purpose.

MMS fails to provide any guidance on how to determine whether crudes are "like" each other. Furthermore, Marathon Oil Company observes that "[t]he term 'sour' does not make crude comparable. Wyoming Sour and West Texas Sour crude oil bear no resemblance to each other in terms of quality, and user access, or liquidity."[26] According to the new rule, a producer might have to base the value of its Wyoming Sour on a price differential between WTI at Cushing and West Texas Sour at Midland.

MMS will allow a lessee to request, in writing, that MMS calculate a differential if no published differential applies, but MMS provides no guidance on how unlike the market center oil a producer's oil must be before the producer can request a differential nor on how MMS would calculate a differential in such a case. As a result, MMS could receive many requests for differentials, some of whose values will be uncertain. Texaco, for example, has production in the Gulf of Mexico which is sold in a variety of locations, none of which are MMS designated market centers. Under the proposed rule, MMS could receive a request for a differential for oil going to each of those locations so that Texaco could assure that it pays proper royalties. MMS' calculation of such differentials would require assessments of each producers' sales and would likely generate multiple differentials for the same "alternate market center." This concept directly contradicts the proposed rule's purpose of adding certainty to the valuation of Federal lease production.[27] Such requests for exceptions for quality and location differences will impose additional filing costs on lessees and increase the workload and paperwork burden on MMS as it processes these requests.

[26] Marathon Oil Company comments to Minerals Management Service, page 16. May 27, 1997.
[27] Texaco Inc., page 14.

E. *MMS' proposal to issue an interim rule creates risk and could substantially increase the systems costs imposed on lessees if the rule is substantially changed in its final form.*

MMS' intention to publish an interim rule has prompted many comments by the industry over the additional burden that would be created if an interim rule is issued, as well as over MMS' legal authority to issue an interim rule.[28] As Vastar Resources, Inc. states, "Changing royalty valuation methods results in huge costs to both the agency and to the regulated community....The possibility of future changes injects a risk that cannot be quantified into those calculations [of cost] and discourages lessees from pursuing operations."[29] The proposed rule would impose costly alterations in the record-keeping systems of companies, and these alterations may need to be changed in a year when MMS issues its final rule. As the Domestic Petroleum Council (DPC) notes, proceeding with the interim rule will only exacerbate MMS' underestimate of the compliance cost.[30]

F. *The restriction on oil subject to crude oil calls is too broad.*

Under the rule as originally proposed, a lessee may not pay royalties on gross proceeds if the crude oil is subject to a call. The restriction would apply even if the call is never exercised. As DPC notes there is no reason to suspect that a privately negotiated crude oil call would leave the call owner or the callee any less eager to maximize his income.[31] Determining which oil is subject to a call would place an enormous burden on companies, as not every right of call appears in a document recorded in government title records. Some are merely referenced in title documents, and some are 50 or 60 years old. Compliance with this provision would require a title examination for each lease.

In the supplementary proposed rule, MMS concedes that excluding all oil subject to call was "too broad" [page 36031]. Under the supplementary proposed rule, only oil subject to a non-competitive crude oil call would be valued using an index methodology. This change would reduce the number of leases where the index methodology would apply. The Form MMS-4415 paperwork burden would not, however, be changed. Buy/sell or exchange agreements would still be reported without regard to whether the crude oil is subject to a call, and arm's-length sales of crude oil subject to call was not to be reported on the form even under the original proposed rule.

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[28] The companies and associations commenting on the issuance of an interim rule are too numerous to cite. They include: Apache Corporation, Chevron Pipeline Company, Conoco, Inc. Exxon Company U.S.A., the Independent Petroleum Association of America, the Independent Petroleum Association of Mountain States, Marathon Oil Company, Shell Oil Company, Spirit Energy 76, the State of Wyoming, Office of the Governor, the Council of Petroleum Accountants, the Rocky Mountain Oil and Gas Association, Vastar Resources Inc., Texaco Inc., Mobil Business Resource Corporation, the Domestic Petroleum Council, BP Exploration & Oil, Inc., and Barents Group LLC.

[29] Vastar Resources Inc. Comments to Minerals Management Service, page 2. May 28, 1997.

[30] Domestic Petroleum Council. Comments to Mineral Management Service, page 4. May 27, 1997.

[31] Domestic Petroleum Council, page 24.

5. SUPPLEMENTARY PROPOSED RULE NOT RESPONSIVE TO REQUIREMENTS OF PAPERWORK REDUCTION ACT

The supplementary proposed rule does not address the substantive issues raised either by industry or by OMB. MMS has addressed only minor issues and in so doing has created new problems.

SUPPLEMENTARY PROPOSED RULE DOES NOT ADDRESS CONCERNS PREVIOUSLY RAISED BY INDUSTRY AND OMB

For many companies, the supplementary proposed rule does nothing to substantially reduce the burden or the cost associated with the filing requirement of Form MMS-4415. The only concession that MMS makes is to require Form MMS-4415 for exchanges between an aggregation point and a market center only. MMS is still asking for comments on collecting information on transactions between two aggregation points. It is possible that any interim or final rule will also require the new form to be filed for these transactions.

MMS also states in the proposed rule that where only Federal oil is commingled, it would only collect information on the transaction involving the Federal oil, but it is unclear how transactions involving both Federal and non-Federal oil will be handled.

MMS has done nothing to reduce the cost that will be incurred by companies to comply with the proposed rule. Form MMS-4415 has not been changed, and so the costs associated with completing it – the cost of upgrading contract and administrative systems and the staff time to complete each form – remain the same. The requirement for certain companies to use actual transportation expenditures also has not changed, and so the cost of calculating those expenditures remains.

Similarly, MMS has done nothing to define more clearly what constitutes like quality oil, and so both MMS and the companies will have to bear the burden of requests for specific differentials for small differences in quality and location.

MMS also still plans to issue an interim rule, so that all the costs associated with a potential change in the system after a year of operation remain.

MMS has done nothing to clarify the instructions to the form nor to address the issue of who is required to file Form MMS-4415. Nor has MMS clarified how the information collected on Form MMS-4415 will be used.

In short, MMS has not adequately addressed any of the substantive concerns raised during the comment period. The PRA gives OMB the authority to reject any information request if it determines that an agency did not adequately respond to the comments it received. It seems clear that MMS has failed to respond to the comments raised by industry and OMB in its supplementary proposed rule.

SUPPLEMENTARY PROPOSED RULE CREATES NEW PROBLEMS

In addition to not adequately responding to comments by industry and OMB, the supplementary proposed rule creates new problems. As discussed in our May 28, 1997 report, the supplementary proposed rule would create serious problems for the utility of any collected information in determining a market value at the lease. It should be recognized that the revised filing requirement could lead to market distortions that would thwart MMS' efforts to collect reliable and representative data. MMS' supplementary proposed rule may effectively force some companies to restructure transactions so that they will not trigger a costly Form MMS-4415 filing requirement.

If this should happen, MMS may find that only one, two, or perhaps no companies at all provide relevant data for some aggregation point/market center pairs that already have relatively few parties engaged in exchange or buy/sell transactions. A small number of responses means that the sample of data available to MMS for estimating average "location/quality" differentials would be reduced, making such estimates even less reliable and leading to inaccurate royalty valuations for those lessees required to rely on that information.

In addition, this revised filing requirement could worsen the problem of appropriating different costs on different lessees that are not related to the number of leases they own or the volume of oil they produce. Companies would only be required to file Form MMS-4415 for transactions between an aggregation point and a market center. Two very similar companies may have very different reporting requirements if one conducts business between an aggregation point and a market center and one does not. Again, the filing burden could cause some companies to restructure their transactions.